DOCUMENT RESUME

ED 386 338 RC 020 076

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TITLE The Real Property Tax and K-12 Education.
PUB DATE Jan 95
NOTE 11p.; In; Increasing Understanding of Public Problems and Policies, 1994. National Public Policy Education Conference; see RC 020 070.
PUB TYPE Information Analyses (070) -- Speeches/Conference Papers (150)

EDRS PRICE MF01/PC01 Plus Postage.
DESCRIPTORS Assessed Valuation; *Educational Finance; Elementary Secondary Education; *Finance Reform; Land Use; *Property Appraisal; *Property Taxes; Public Policy; *School Funds; School Taxes; Tax Allocation
IDENTIFIERS Farmland; Reform Efforts; *Tax Equity

ABSTRACT

The real property tax is local government's primary source of revenue, providing 48 percent of local governmental revenues nationwide. Of all local government expenditures, 37 percent go to elementary and secondary schools. Therefore, problems with property tax become problems of school finance. Taxes and subsidies generally do not change the underlying value of land, only the distribution of interests between public and private landowners. The preferential assessment of farm, open space, and forest lands represents a nearly universal program subsidy by local government to landowners. USDA findings suggest that revenue losses by new entries receiving preferential assessment are greater than the revenue gained by lands leaving preferential assessment, and that preferential assessment does not preserve agricultural land use. The real property tax can be improved by levying taxes on property in proportion to value; eliminating exemptions; assessing land and capital improvements separately; appraising and assessing at 100 percent of market value; reducing the number of classes and categories of land for differential assessment or rates; eliminating caps, circuit breakers, senior preferences, and other forms of social engineering through the real property tax system; and incorporating appraisal and assessment activities into a comprehensive geographic information system. Contains seven references. (TD)

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THE REAL PROPERTY TAX AND K-12 EDUCATION

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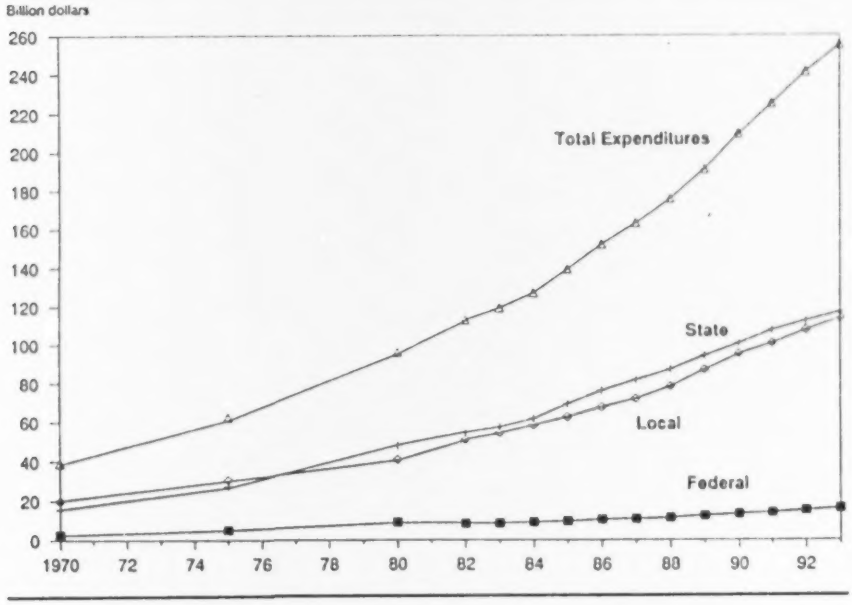
Property taxes provide 48 percent of local governmental revenues (taxes plus state and federal aid) nation wide. They are local government's primary source of revenue. The real property tax has been and continues to be the basic source of local revenue. Furthermore, of all local government expenditures, 37 percent go to elementary and secondary schools (U.S. Department of Commerce, 1993, p. 45). The cost of educating our nation's youth has increased significantly and rapidly in the past 10 years (Figure 1). The responsibility for paying for these increased costs often falls to local governments and citizens. Problems with property tax, therefore, become problems of school finance. These issues trouble a number of researchers, policy makers and extension educators. Our efforts in this session are to touch some of the concerns. While it is not possible to address all aspects of school and local government finance, perhaps a few of the

Figure 1. Expenditures for Public Elementary and Secondary Schools and Finance Sources, 1970-93



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basic facts and problems of the real property tax can be discussed. Then we can examine some possible areas for change in finance mechanisms. While we cannot examine all issues, we focus on two questions: school finance and property tax administration. Let's see what some of our colleagues are saying and considering.

Nationally, the real property tax constitutes three-fourths of the tax revenue raised by local governments. According to the U.S. Department of Commerce, in 1991, local governments got $161.8 billion of their $339.9 billion of general revenue from own sources (1993, p. 2). Of that general revenue from own sources, 63 percent is taxes and the remainder fees and charges. Of these local government taxes, 75 percent are property taxes (Table 1). And of the property tax revenue, about 90 percent is from real property (Table 1) (U.S. Department of Commerce, 1989, p. 7).

The real property tax is based on the real estate's long-run value and may be high or low in relation to any particular year's earnings. The market value of real estate is net earnings capitalized at some appropriate rate of interest. Since net earnings are earnings after taxes, the value of the capitalized tax represents a public value over and above market value. For example, a value of $2 trillion from capitalizing the 1987 real property tax of $105 billion at 5 percent might be added to the $12 trillion of U.S. land and structures estimated for 1987 by the National Realty Committee. The combined $14 trillion value might be termed the national asset value of real estate (National Realty Committee, pp. 2, 96).

Farmland values, too, have a private and a public dimension. In 1993, the market value of farm real estate was $685 billion (U.S. Department of Agriculture; Shoemaker). If the comparable year's tax of $4.9 billion were capitalized at 5 percent, for example, the public interest via the real property tax would be $98 billion (Gertel). The national asset value of farm real estate of $783 billion represents the true productive value of the land and the $685 billion is the private or market share of the real estate. If the tax were raised to $6 billion, the market value of the real estate would drop to $663 billion. The value of the land would not change, but the lower market price would reflect the higher tax.

Similarly, if the real property tax is reduced by exempting part or all of the value from taxation, for example, the market price of the exempted property will increase. Decreases or increases in the taxes on land can create windfalls or wipeouts for the property owners, but they do not change the underlying value of the land. Changes in the tax only change the distribution of value between the public and the private landowners. All the redistributive advantage of preferential assessment of farmland went to the owners of the farmland at the time the various laws of the 1970s were implemented. All subsequent purchasers simply paid a higher market price for their farmland in exchange for lower taxes.

Table 1. Revenue from Property Taxes, 1956-57 to 1990-91 (dollar amounts in millions)

Fiscal Year	State Governments			Local Governments		
		Percentage of			Percentage of	
	Property Tax Revenue	Revenue From All Sources	Total Tax Revenue	Property Tax Revenue	Revenue From All Sources	Total Tax Revenue
1990-91	6,288	1.0	2.0	161,772	26.4	75.3
1989-90	5,848	0.9	1.9	149,825	25.5	74.5
1985-86	4,355	0.9	1.9	107,356	24.7	74.0
1981-82	3,113	1.0	1.9	78,805	25.2	76.0
1976-77	2,260	1.1	2.2	60,267	30.7	80.5
1971-72	1,257	1.1	2.1	40,876	36.1	83.5
1966-67	862	1.4	2.7	25,186	39.0	86.6
1961-62	640	1.7	3.1	18,416	42.6	87.9
1956-57	479	1.9	3.3	12,618	43.4	87.0

Source: Bureau of the Census, Census of Governments, Government Finances.

Other distributions between the public and private interests in land include regulations that limit land use options. The regulations could take the form of a tax or, by enhancing the attractiveness of a neighborhood, a subsidy. Government may rent land for desired purposes, as in the Conservation Reserve Program (CRP), or it may buy land for roads or utilities, or purchase easements for particular purposes. Except as government intervenes to change basic supply or demand features of land, taxes and subsidies do not change the underlying value of land, only the distribution of interests between the public and private landowners. The preferential assessment of farm, open space, and forest lands represents a nearly universal program subsidy by local government to landowners.

Preferential Assessment Favors Farmland

Since the early seventies, fifty states have modified their real property tax laws to encourage using land for agriculture, open space and forestry. Provisions of state tax laws vary widely, but they commonly appraise and assess in terms of current use rather than a market value that takes into account projected future uses. Farmland is valued as farmland rather than future residential homesites. Land use assessment is intended to align the annual tax payment with the current annual earning capacity of the land, rather than the value of land as an asset (Aiken; Malme).

Rationales for subsidizing agriculture, open space and forestry through preferential tax assessment vary widely. One argument cites lower levels of public services associated with low-density settlement. Low-density agriculture and forestry mean fewer school children. Even at higher per capita costs, the total costs for education may be lower in communities with low-density residential development. Through the eyes of the public fisc, agriculture, industry and commerce earn, but babies and school children cost.

A precise estimate of how much subsidy owner/taxpayers receive through preferential assessment of their farmland may be incalcuable, given the detailed laws of fifty states. Minnesota requires that the taxpayer receive one-third of his/her family income from the land to receive the preferential assessment. Wisconsin allows qualifiers to deduct their property tax from the state income tax to such an extent taxpayers may get a refund. In those states that have used the real property tax for social engineering, the calculation of the subsidy equivalent of preferential assessment is difficult (Anderson; Michos).

A partial estimate of the subsidy equivalent of the preferential assessment of the real property tax may be derived from data acquired by the U.S. Department of Agriculture (USDA) in its annual survey of local tax officials. For example, the difference in per-acre tax rates for farmland with and without a preferential assessment

was 5 percent and 6 percent, respectively, in 1991 and 1992, the latest years for which data were collected. Those percentages translate into subsidy equivalents of $237.2 million and $292.1 million for the two years.

By reading, in that same USDA survey, changes in tax levies for parcels going on or off of preferential assessment, one gets another perspective. Levies on farmland parcels with preferential assessment in 1991 and without in 1992 increased 17 percent over 1991. However, levies on farmland parcels without preference in 1991 and with preference in 1992 dropped 33 percent. These findings suggest that the revenue losses by new entries in preferential assessment are greater than the revenue gained by lands leaving the preferential assessment.

Does preferential assessment preserve agricultural, open space or forest land use? According to Malme, "There is general consensus from extensive research over a twenty-year period that the economic incentive offered by lower property taxes has had minimal effect in preventing conversion of farmland to more intensive uses" (Malme, p. 22). In nineteen states there is no rollback feature to "penalize" the conversion of land. In other states the rollback feature is nominal, forming little disincentive to convert to other uses when it is otherwise profitable. Wunderlich estimated that eliminating the economic competition from nonagricultural forces on the value of agricultural land would require a subsidy of more than twice the entire real property tax paid on agricultural land. Real property taxes, to be an effective land-use policy instrument, should approximate the incremental value of a land-use conversion.

A Fair Tax When Administered Evenly

Policymakers may view taxes as sources of revenue, incentives for resource use and mechanisms for welfare. Taxpayers, for any particular tax, however, are interested primarily in equitable treatment. An equitable real property tax assesses the same rates on equivalent properties, but the effective distribution of the real property tax is uneven. Taxes per acre vary widely among states (Figures 2 & 3). Such variations are the result of differing levels of services demanded by citizens in different regions of the country, differences in efficiency of governments in providing the services, and differences in the bases of taxes and other fees, charges and revenues. Within the states, taxes on individual parcels will vary with the various parcels' quality and use value. Such differences, however, do not generally relate to the fairness or equitability of the tax.

The unevenness that bears on fairness relates to equality of burden of taxes. In an *ad valorem* real property tax, equality of burden means that government takes the same share of value from all properties. If the government takes a larger share of value from large-

Figure 2. Agricultural Real Estate Taxes, Average Per Acre, 1992

Source: Economic Research Service.

Figure 3. Agricultural Real Estate Taxes per $100 of Full Market Value, 1992

Source: Economic Research Service.

valued properties, the tax is progressive. If the government takes a smaller share of large-valued properties, the tax is regressive. The bar chart based on data from a landownership follow-on of the Census of Agriculture (U.S. Department of Commerce, 1988) suggests an overall regressivity in effective real property tax rates in the United States (Figure 4). Similar regressivity was found in an overwhelming majority of state farmland tax rates (Figure 3).

Conceptually, the *ad valorem* real property tax is neither progressive nor regessive, but neutral. However, as Figures 4 & 5 show, the rate of real property tax in dollars per $100 of value for the largest landholdings is about one- third that of the smallest landholdings. Analysis reveals that very little of the apparent regressiveness is due to a "state effect." Furthermore, Wunderlich and Blackledge found steep regressiveness in all but four slightly progressive states and five neutral or slightly regressive states. Explanations based on owner characteristics such as age, race, residence and occupation are both intuitively and statistically inadequate.

By elimination, Wunderlich and Blackledge tentatively concluded that regressiveness is due primarily to the administration of the tax, perhaps the assessment process. The findings mean that large-valued properties are systematically under-valued relative to small-

Figure 4. Real Property Taxes Per $100 of Value, 1988

Owners in the top class of landholdings ($5 million or more) pay tax rates about one-third of rates on owners in the bottom class.

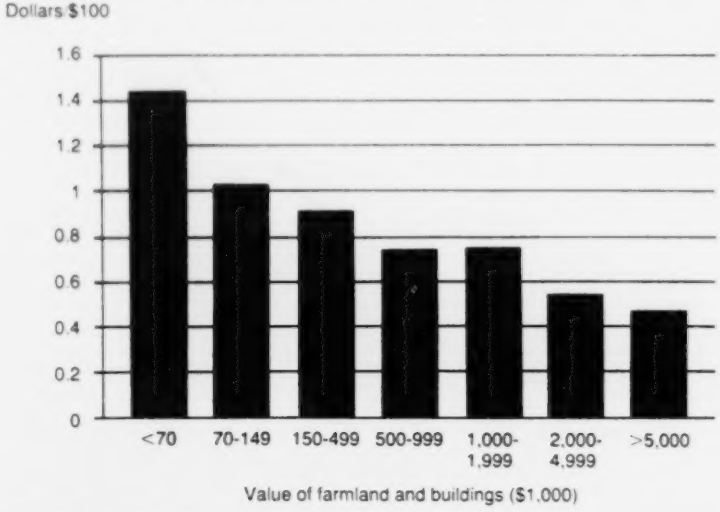

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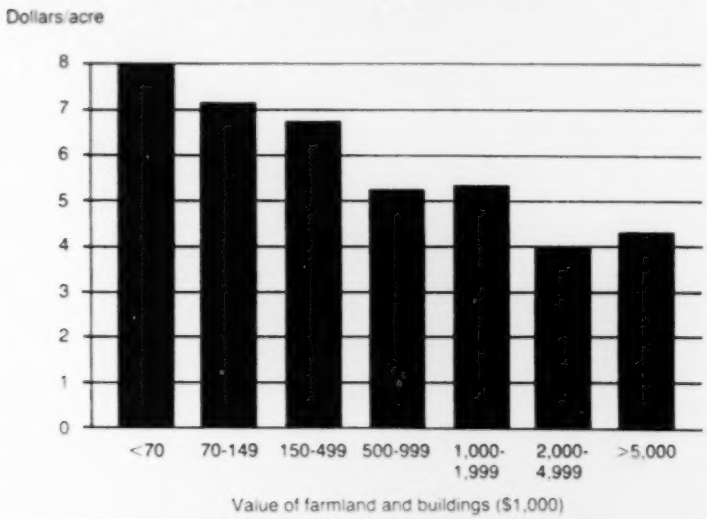
Figure 5. Real Property Taxes Per Acre, 1988

Taxes per acre follow the same general pattern as taxes per $100.



valued properties. If, for example, the farmland owners in that class of holdings valued at $5 million or more were to pay taxes at the overall average rate, their total taxes would increase from $264 million to $477 million, or from about 5 percent to 9 percent of the $5 billion real property taxes on U.S. farmland. Potentially, local government revenues could increase, small holder's tax bills could decrease, or both.

The effective rate of taxation, and the factors affecting the rate, can only be determined with careful study within the environment of each state's laws and administration. The assessment and taxing as a process has potential for generating much of the information needed for its own evaluation. That information should be organized and used.

The Real Property Tax Can Be Improved

An improved property tax system, while unlikely to solve all K-12 education finance problems, could contribute to education finance while providing other public services. Economically, the land tax has much going for it. To the extent that the quantity of land is unalterable except by the application of labor and capital, supply is inelastic. Rent is pure. A tax on land, therefore, has little effect on the level of its use. Paul Samuelson, in his classic economics text, wrote, "Pure land rent is the nature of a 'surplus' which can be taxed heavily without distorting production incentives or efficiency" (Samuelson, p. 541). By the same reasoning, a tax on labor may deter workers from working as hard or long, and a tax on capital may lower the rate of capital formation. Income, value-added, and sales taxes are more likely to cause economic inefficiences than taxes on land rents or values. The first improvement in the tax system should be to replace taxes on labor and capital with taxes on land, where possible.

One argument for maintaining or increasing the shares of revenues raised locally is the autonomy and control over budget and programs, such as schools, it allows local jurisdictions to retain. Raising funds locally also may encourage fiscal discipline and greater citizen involvement, since the real property tax is directly related to the resources of the community.

Clearly, the real property tax will not yield revenue sufficient to accommodate all the services of local government, so other sources of revenue are necessary. However, the real property tax can be improved while remaining an important source of revenue. Here are some of the ways a real property tax can be modified to make it more acceptable if more revenue must be raised:

- Levy taxes on property in proportion to value. The presumption of equitability of the *ad valorem* tax is that land of comparable value will be taxed at the same rate whether in large or small quantities. The *ad valorem* tax is neutral in concept, neither progressive nor regressive, but deviations apparently occur.
- Eliminate exemptions to reduce the complexity of assessment and computation of levies as well as broaden the tax base. In its Census of Governments, the U.S. Department of Commerce identified major categories of land owners completely exempted from tax in eighteen states and a wide range of partial exemptions in thirty-one states. Nongovernment property exemptions result in more than 7 percent of the assessed value of nongovernment property standing untaxed (Behrens).
- Assess land and capital improvements separately and shift the tax toward land and away from improvements to provide incentive to owners. The shift from improvements to land can be achieved without individual tax increases. If, as recent studies show, buildings represent about one-fifth of farm real estate values (Canning), an increase in land taxes should permit a fivefold reduction in building taxes with no loss in revenue.
- Appraise and assess at 100 percent of market value so the assessing process is clearer to the taxpayer and calculations are not unnecessarily complicated (Behrens). Some state constitutions will need amending.

- Reduce the number of classes and categories of land for differential assessment or rates. Adherence to 100 percent of market value precludes special classes of land.
- Eliminate caps, circuit breakers, senior preferences and other forms of social engineering through the real property tax system. Provide the holders of substantial landholdings but low annual returns, the option of paying taxes with equity claims.
- Incorporate appraisal and assessment activities into a comprehensive geographic information system. Further, adopt computer- assisted mass appraisal to provide annual reassessments and improve the quality of land information available to office and citizen. Examine the possibility of self-assessment in the administration of property taxes.

For farmland, the preferential-land-use assessment is controversial. If only land, not buildings, is assessed at present (agricultural) use, the burden of tax is shifted from land to buildings and building improvements are discouraged. But building and maintaining farm buildings might be the strongest incentive to preserve farming. And preferential assessments without full value rollbacks actually encourage speculating with farmland for capital gains. America has more than two decades of experience with land- use value assessment, and reexamination, possibly reform, is in order.

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